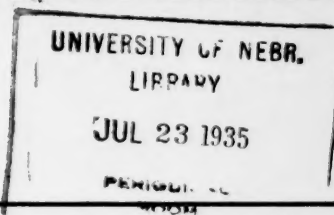

The New York
Certified Public Accountant



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**PROBLEMS AFFECTING CREDIT EXECUTIVES *and*
ACCOUNTANTS**

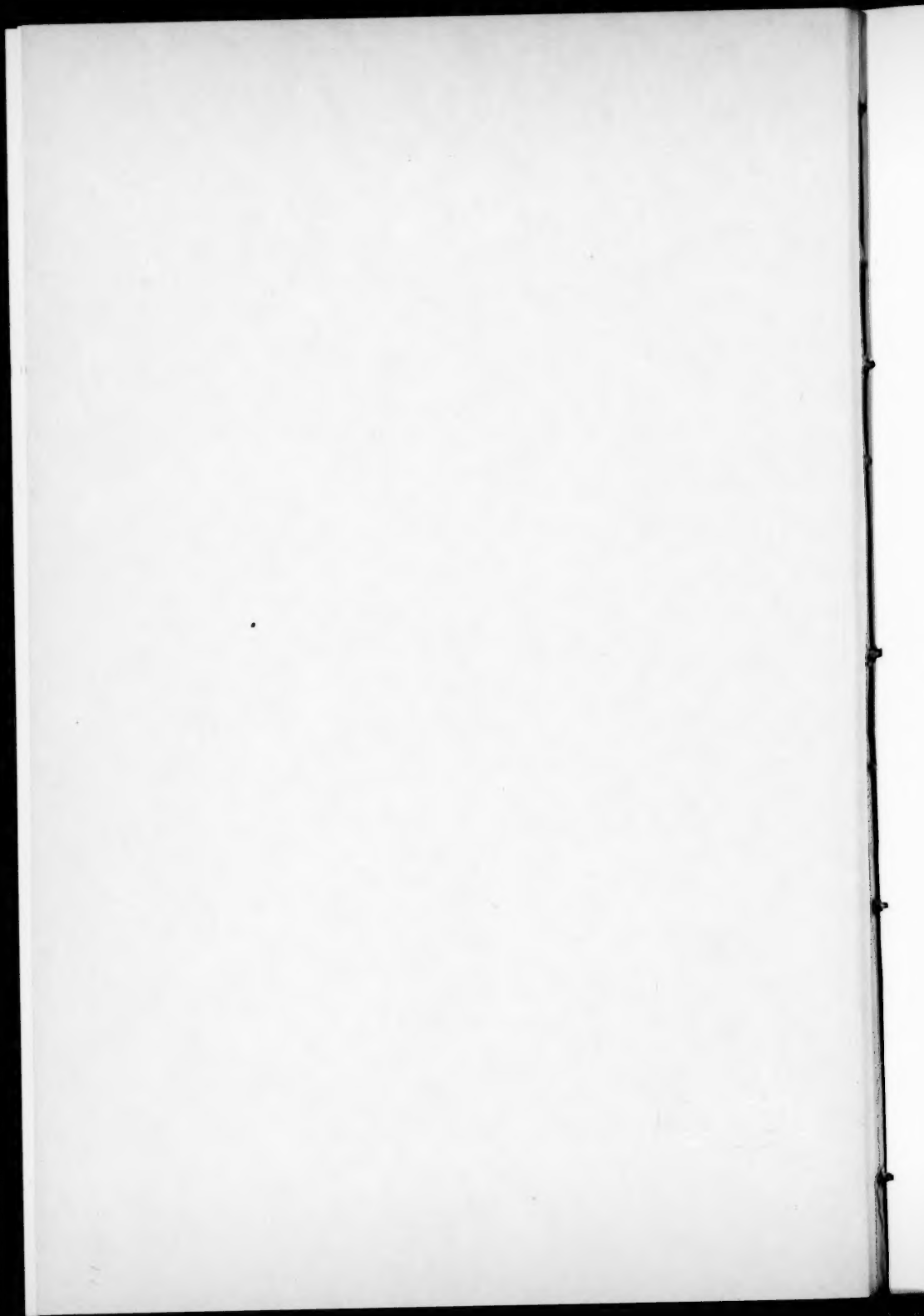
INVENTORY METHODS *of the* APPAREL INDUSTRY

ACCOUNTANTS *and the* PUBLIC SERVICE

AUDITING *of* MUNICIPAL ACCOUNTS

Published Quarterly by

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS



Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—*From the Certificate of Incorporation.*

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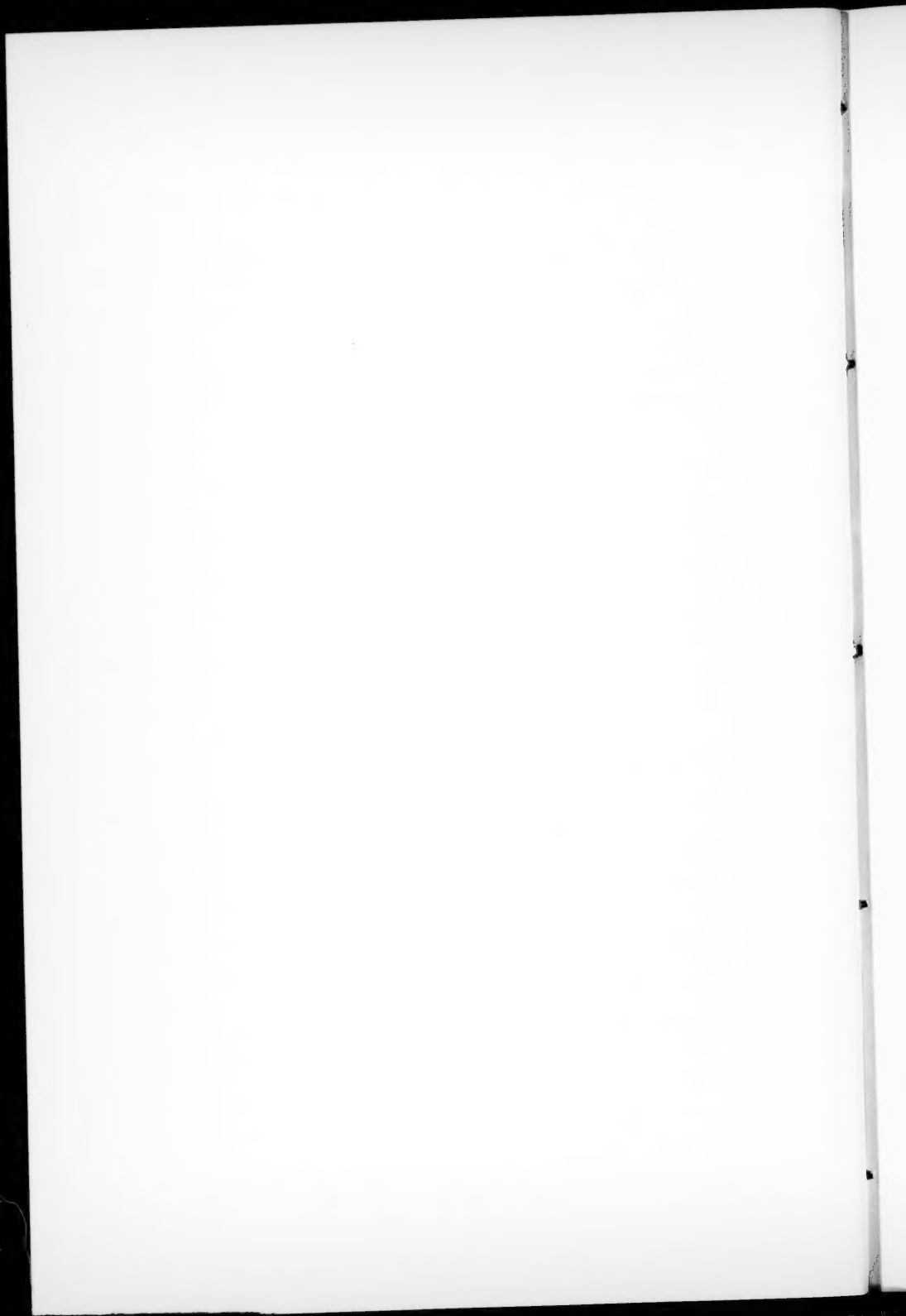
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OFFICE OF THE SOCIETY
30 BROAD STREET • NEW YORK



Problems Affecting Credit Executives and Accountants

Address of COLONEL ROBERT H. MONTGOMERY, C.P.A., and discussion at a forum session of the New York Credit Men's Association on May 7, 1935, at the Hotel Commodore, New York City.

LEE S. BUCKINGHAM, chairman of Forum Committee: The forum sessions for the year would not be complete nor would they be a success if we did not have one evening devoted to the subject of accounting in conjunction with our good friends, the certified public accountants.

As credit problems develop it becomes more and more apparent each year that there is so much in common between the certified public accountant and the credit executive that they must understand each other thoroughly. These meetings, therefore, are most essential.

We are always gratified and pleased when we have as our guest the speaker who is going to address us tonight. I am glad to present Colonel Robert H. Montgomery, whom we all know.

COLONEL MONTGOMERY: It has always been a pleasure to come before this gathering, and I am sure it will be tonight. We have always met each other frankly, and before the evening has gone its course there have always been questions, some of which were, perhaps, difficult to answer. But they have always been interesting, and I hope, as I proceed with the presentation of several matters of mutual interest, that those of you who have questions in mind which may have accumulated since the joint meeting of this Association and the New York State Society of Certified Public Accountants in December, 1933, will give the meeting the benefit of those questions. They will be answered, if possible.

I recall that the last time I spoke before this Association—prior to the joint meeting—the question was raised as to the value of accountants to credit executives, and some criticisms were made of accountants' reports and certificates. I asked at that time whether all of the accountants who were being criticized were members of the New York State Society of Certified Public Accountants, and it developed that they were not. I suggested then, and I repeat tonight, that it seems unreasonable that when you have such a large and representative organization of your own, which is outstanding in the world of credit grantors' but which does not include all credit executives, that you should not in turn recognize that all of the accountants of this city and state are not members of the New York State Society and, therefore, not subject to its rules of ethics. The Society is trying, however, to bring all of the practicing certified public accountants into its membership. It now has 2,175 members, and that makes it a rather large and representative organization. It gives a wide field from which the business community may select its accountants, so that there never could be any question about certain accountants being unduly favored. I want,

moreover, to emphasize the efforts of the Society through its various committees to improve the standard of practice and ethics.

I made some inquiries last week and I was very happy to find that during the last two or three years there were very definite and specific evidences of closer relations between the members of your organization and the members of the New York State Society. I am hopeful that that relationship will continue and expand, and I think that one way of doing it is to have joint committees from the two societies who will get together as we did in December a year ago and arrange another joint meeting of the two organizations. I think that was a great success.

So I wish that in your program for next winter you would bear that in mind. I think it would not be out of place for me to introduce to you the next president of the New York State Society. If he will stand up you will know his name, but I want you all to greet James F. Hughes.

I assume, Mr. Hughes, that I can speak for you in saying that you will not only do as much as has been done in the past in promoting cordial relations between the two societies, but you will do much better.

JAMES F. HUGHES: I shall try with your help, Colonel.

COLONEL MONTGOMERY: This Association was very helpful to the accountants recently in connection with the perennial bill purporting to regulate accountancy in the state which was introduced, as usual, in the State Legislature and which managed to get up to the Governor. It is, of course, from our point of view, a highly pernicious measure. After analyzing it in all details your organization agreed with that viewpoint, and it was helpful in expressing that disapproval in Albany. On behalf of the accountants, I want to thank its members for what they have done.

In your memorandum, you pointed out clearly the numerous flaws in the bill. In the memorandum of another organization of credit executives, the Uptown Credit Group of the National Federation of Textiles, it was stated that its members pass on a billion dollars of credits every year. Now in doing that work that organization and your group also must cooperate with and have the assistance of the certified public accountants. As you have recognized us as being useful in the community, it is then entirely in your interest to deal with a body of men which can be controlled; who, through education and experience, and I mean long and worthwhile experience, are equipped to do the sort of work which you think accountants should do. I must say, moreover, that if you are to be guided by your severest critics and your best friends—I think, as I look back over the last fifteen or twenty years, that I can say that each has been that to the other, then you must continue to help us build up the standing of the profession of accountancy and help protect it from legislative raids.

There is one other thing that I should like to mention before I pass on to more technical problems, and that is that the accountants for a number of years have been working towards what they call the closing of books and the preparation of statements on the basis of a natural business year.

This effort has made some progress but not nearly enough. Over a long period of years the public accountants have had a congestion of work during the first two or three months of the year that has made it difficult to get through with it in the time permitted.

Cost of public accounting work has always been a source of discussion between client and accountant. That cost up to the present moment has been unduly increased by the fact that the accountants must carry an organization through twelve months in the year on a certain volume of work, with a majority of it being done in about five months. If all of the work were done in that time you can see what an overhead that would throw on the less active months. It is true that in certain industries they would not think of closing their books, or making up their annual statements, as of December 31st, but these industries are too few and more must adopt the natural closing date.

I do not know of any organization that would have more influence in bringing about further changes than the New York Credit Men's Association. In many cases all you would have to do, I think, would be to urge it; and you certainly are not being asked to do it unless you, for yourselves, think that it is wise and of value to those who have to do the work. There are certain industries which have been, up to date, closing their books as of December 31st in the midst of a busy season, when the question of inventories and many other things have made it practically impossible to prepare as accurate a balance sheet as could be prepared at the close of a natural business year. In those same industries there are, perhaps, two or three times during the year when it would be comparatively simple, but I do not have to expatiate at length on that. I ask that you give serious consideration to this problem which is as much yours as ours.

I would like to ask if there is any objection to doing that in industries. I will say very definitely, on the part of the accountants, that if it could be brought about to any substantial degree the cost of the audits could be definitely lowered. That should mean something.

W. W. ORR, secretary of New York Credit Men's Association: I should like to ask if Colonel Montgomery might enlarge on his thoughts and give an example of what is a natural year in certain lines of industry.

COLONEL MONTGOMERY: I will give you an illustration. Up to not so very many years ago a great many of the public accountants closed their own books on December 31st. They found themselves doing most of their work in the time of year when they were busiest. Now there is a concrete example. How silly it was for us to close our books for the year and make distributions of profits, if any, and make up our tax returns and do all that sort of thing during January and February, the two busiest months of the year!

I think that all accountants have changed their fiscal years to the summer, or early fall, when an accountant's business is at ebb tide and he

can spend just as much time in contemplation of the preceding twelve months as he wants to.

MR. BUCKINGHAM: I should not be surprised, Colonel Montgomery, if it is not a matter of habit with a great many credit men to secure the December 31st balance sheet, and look forward to December 31st and June 30th, and take it for granted that they must have it at that time.

P. M. HAIGHT, president of New York Credit Men's Association: Did not the institution of the income tax have a good deal to do with that?

COLONEL MONTGOMERY: It had something to do with it. The 1909 Act called for the statements as of December 31st, but that only applied to corporations, and in the 1913 Act permission was given to report at another time, so that for twenty-odd years it has been permissible to make up statements on the basis of a natural business year.

MR. BUCKINGHAM: The reason for favoring it is apparent, of course, from your point of view.

COLONEL MONTGOMERY: Well, if it is apparent, and we say that we could definitely reduce the cost of audits if they were spread over the year, why should not we have your help?

MR. BUCKINGHAM: I know of no reason why you should not have our help, except, as I said, credit executives have been in the habit of getting these balance sheets at that time, and habits are difficult things to change.

MR. ORR: I notice in the daily papers again and again that reference is made to the quarterly statements of corporations. Now I suppose that in recent years they began the quarter January 1st and ended March 31st, but I do not see why the year might not end March 31st, and still have the audits made at that time.

MR. BUCKINGHAM: Of course, there is the matter of comparisons.

COLONEL MONTGOMERY: Those comparisons, when they commence to be made by quarters, would be just the same if the annual closing is March 31st or September 30th.

QUESTION: Is not the taking of the physical inventory the biggest objection to closing the books at the end of September? We have overcome that by taking it at the end of November. In fact, mill supplies and items like that are taken at the end of October, and in that way books can still be closed at the end of December, with the inventory taken partly in October and partly in November. Our cost of auditing has been cut that way.

COLONEL MONTGOMERY: I well remember one of the first audits I was sent out to make in the iron and steel region of Pennsylvania. It was a December 31st audit, and I was there in January or February. I was called on to make some comments on the inventories. The corporation officials said that pig iron could be very easily tested by just taking the measurements; the piles were so many feet long and so many feet high.

I went out into the yards to do it and they were completely covered with snow and had been for a month, and yet they expected us to pass on it.

One other matter as to the cooperation between credit executives and accountants is this. Your Association has among its members those who deal largely with particular industries and trades, and they have highly technical problems in those industries and trades that can hardly be dealt with in general meetings. In the New York State Society there are some forty technical committees dealing solely with technical subjects. I should think that it might be a very useful thing if a liaison could be effected there. I do not know just how you would bring it about, but if it were known, perhaps, to your members that the New York State Society has a technical committee dealing with accounting and cost problems of stock brokers, for instance, the stock brokers in your Association might like to get together with them once a year. I do not know how active the Committee on Stock Brokerage Accounting has been during the last year or two, but there are some committees that are very active, and those committees do deal with many of the daily problems of the members of your Association. Do you think something might be done about that suggestion?

MR. HAIGHT: I think that would be helpful. Could you let us have a list of those committees?

COLONEL MONTGOMERY: That can be done. Will you make a note of that, Mr. Hughes?

MR. BUCKINGHAM: We can publish it in the CREDIT EXECUTIVE, too.

COLONEL MONTGOMERY: I suppose, Mr. Hughes, you are going to appoint all those committees?

MR. HUGHES: I expect to have them ready soon.

COLONEL MONTGOMERY: It was suggested to me that I say just a few words on the subject of budgets.

All of these things that I shall discuss are rather well outside of what I think is the conventional balance sheet, because after all, when looking at it from the accountant's point of view, and how we can best work with the credit executives of the city, the mere receipt by you of a plain balance sheet on one sheet of paper with a certificate at the bottom is not very much. That is the reason I wanted to get outside of it. We do not claim that it gives very much, and I think in the past some of the very unfortunate experiences that you had with balance sheets that had a certificate attached and which afterwards turned out to be highly inaccurate, were because you perhaps placed too much dependence on them. If, over a period of years, credit executives had dealt with accountants on something else than a pure balance sheet basis we could have worked out some of those unfortunate situations.

I do not know whether members of your Association ask for budgets. The banks of the city have taken the matter very seriously, and they feel that it has been decidedly helpful to them to ask practically every borrower to submit a budget for the succeeding period, whatever it may be, three

or six months; very rarely as far ahead as a year. This may be more valuable than his statement, and profit and loss account, all dealing with the past. The prospective borrower may tell the banker, or he may write out in answer to a few questions what his booked sales are and certain other things, but that does not take the place of a budget.

You ask somebody who is seeking a considerable line of credit, "Let me have your budget for the next six months." He will say, in all probability, "I have none; I never made up a budget." Well, I think that is an admission, or rather a statement, which usually would not be true, because in these days how could a reasonably good business man look forward to the next six months of business without at least, in his own mind, picturing the gross sales which he feels he would have to make, picturing his prime costs; if he is advertising he must have in mind his advertising program for the sales for the next six months and also what would happen if he did not reach those figures which he feels are reasonable when he is forecasting.

In other words, a budget along rather definite and conventional lines is an extremely simple thing, and without going into it at all exhaustively, I would like to throw out the thought that during the last few years it is something which has been tremendously useful in many cases. I have known of clients who have expected to borrow money and who have been asked for budgets which they had never prepared before. After preparing them they have gone to the credit grantors with those budgets, and the credit grantors, by going down the columns, have often been able to say, and have said, "You cannot do it." These credit grantors have had information regarding the trade or business, financial conditions, export and import conditions, which has indicated to them that over the next six-months period those hopes could not reasonably be expected to be realized.

Now then, as to the things that are not in a balance sheet. Some years ago I was asked to speak before some cost accountants, and they were so very serious and I knew so little about cost accounting that I was driven to finding a formal subject which I was almost tempted, the other day, to give to Mr. Orr when he asked me what I was going to talk about. I think the subject was this: "The Futility of Precision, or the Curse of Balancing."

Now if you will think of that for a moment and apply that to a balance sheet, it comes close to what I think of many balance sheets. If you are looking for precision and balancing, you are making a bad start. You want precision because everything must have dollars and cents and must be in the books in order to get it on the trial balance, and after it is all over it must balance, and that has led to many false balance sheets, false because the true intent of a balance sheet has been lost sight of and the physical balancing has been the thing in mind.

So if you could do it—I do not know whether anybody would have the nerve to ask for it or not—I think you ought to pick out some of your customers and tell them that the next time they bring in a balance sheet

you do not want it to balance. You should tell them not to ignore their books entirely, but to be perfectly free with the bookkeeper's figures, and as they take from the items of the assets, if the items that are in the books (which balance) are too big or too small, not to hesitate to change them. If there is any item among those assets which they are not willing to swear to, just leave it out.

Then, when it comes to the liabilities, you do not have to tell them that they had better put down all the liabilities that are there, because there would not be any there unless they were actual liabilities; but tell them not to forget those commitments which have been made which very definitely are going to result in losses soon after the date of the balance sheet, and then when they get through, to add up the two columns and let it go at that. Now I do not see why you should not ask for it. Of course, if you call it a balance sheet you are sunk! And that is the reason I speak of the curse of balancing. But you might ask for it in a little more diplomatic language than I have used, and perhaps they would get the idea.

The accountant, when he tackles the balance sheet, is supposed to do that more or less, and that brings us to the question which always arises when accountants talk with credit executives. Do we know anything at all which you do not know better than we do? That is a very disturbing question sometimes. There are many things regarding which you have the superior knowledge. We do not know anything about the actual granting of credits; we do not know many things which we should know, and which would be extremely valuable to us in our work as accountants, which you know, because they are part of your work, and which we never will know. Everything is not new, you know. The New Deal does not apply much that is new, I imagine, to credits. Human nature is much the same, and whether or not a man can carry out his commitments or not depends to a great extent on the old fundamentals. If he has plenty of character and not many assets he will probably pay. But it is a question of experience on your part, the experience which we never can gain.

But on our part we have certain other knowledge and experiences. We have been grounded in certain fundamentals from the time we started to study accounting to and through the time that we practice. There are certain things that we look for, and we think that we can be helpful to credit executives. It is not always necessary that there should be a disclosure of dishonesty, you know that. Of course, that is still a fundamental. There are still those who hand you balance sheets and profit and loss statements which are fraudulent, and there are enough of them so that as a general rule, everybody's accounts should be audited. That is really enough of a reason, because out of every thousand business concerns, so many of them at one time or another submit false balance sheets. But let us assume that they do not; they still make mistakes. Now when I say there is a tendency to make mistakes I am referring to honest mistakes, such as come from the feeling of optimism which is present in each one of us as to

those things which we own, as to their value to us. That is the reason people do not sell out their stocks and bonds after they have gone down one point; they think they are worth just as much as they paid for them, so they hold them until they go down ten points. We are all prone to place sentimental values on our own things. Even in business, the stock on the shelves has sentimental value—I think it is fair to call it that—although to remember the old language that was used, it is chiefly souvenirs.

On the question of our debts and, possibly, liabilities, there is exactly the same feeling. Somebody sues you for a million dollars and you know you cannot pay it and you know you do not owe it, so it is not put on your books. But if some salesman sues you for several hundred dollars, the chances are that you will have to pay something; there is probably a liability there which you will not put on the books.

So, in these and other ways, honest mistakes creep into a great many balance sheets. Almost every item may be affected, the accounts receivable and notes receivable, the inventories, the raw materials, the plant, the fixtures, furniture, as to how much they have been depreciated, and so on through the items of a balance sheet. There the public accountant has had experience. He has had experience with other concerns in the same line of business. He is able in a comparatively short period of time to review the transactions for the year so that having reviewed those transactions, many, if not all, of those honest mistakes will have been corrected before the balance sheet reaches the credit executive.

Now that is a service that no one else can render for you. The corporate officials cannot and will not do it for themselves. Your questions will never take the place of what you could do yourselves, as we do, if you went out on the job and went through the books and reviewed the transactions for the year. Now you cannot do it yourselves, and therefore, you have to work with us. We are just as anxious to do that work creditably and in a manner of value to you as you are to have us do it; and in order for us to do it so that it is of most use to you, we must have a meeting of minds. I think in many cases it would be very helpful if the credit grantors would get permission from the borrower to talk to accountants before an audit is started.

You know, after an audit is finished—and I am now touching on a highly controversial question—there is a certain delicacy of relationship between the public accountant and the credit grantor. If an accountant goes into a client's office and learns all of his secrets he cannot go out the next day and broadcast these secrets. There are certain perfectly obvious things. If the man is insolvent, the reputable accountant is not going to certify to a balance sheet that shows ample solvency. That is obvious. If there is a gross overstatement of accounts receivable, if bad accounts have been on the books for some time and there is no sufficient allowance therefor, that is easy to determine. If there are things in the inventory

that are obviously out of date, obsolete, overstocks and that sort of thing, that may be a simple matter.

But there are many other points in connection with the business. Suppose you find that the accounts are carelessly kept. That is not always a crime; it is not always evidence of inability to pay, because some very highly successful concerns have been careless over a great period of time. But in many other cases carelessness on the part of the clerks and staffs of clients definitely leads to leaks, to defalcations, to losses and bankruptcy. They have been traced to such causes many times.

So, after a job is over there are many delicate things which cannot be discussed with all freedom between the accountant and the credit grantor. But in all cases, before a job is started, the credit grantor can say to the accountant, "We are especially interested in this concern as regards certain phases. We do not care so much about the balance sheet, because if you are willing to say that their accounts have been honestly kept and that you do not find anything particularly wrong about it, that agrees with what we already know. But we are particularly interested in certain developments of their business."

Suppose they are selling to only two or three customers, how are they paying? The accountant can say that the credit executive can get that for himself. How about future commitments? The credit grantor can secure that information. But there are many of those things which could be verified by the public accountant and if he does not do it the credit grantor will get that same biased report that I mentioned before.

So I make the suggestion that if you are particularly interested in credit granting in a large way, perhaps to new concerns, and you know that they are going to have public accountants; you may have had something to do with recommending the audit and having it done, you can say, "I want to talk to the accountant before he does the job."

ROBERT HEIMOWITZ: In connection with the items which would not appear on a balance sheet, you gave as an example a suit that might have been pending against a company. In what way would an audit of the books by a public accountant reveal that condition?

COLONEL MONTGOMERY: An audit would not necessarily disclose matters of that type, but in an analysis of transactions, I think it is safe to say that in probably fifty per cent of all those cases the accountant would know about it before he finished the job. They arise out of all kinds of past transactions. Regarding the suit by the salesmen, there are so many of those cases that an analysis of a salesman's accounts very often brings that to light; there is a balance on the books, usually on the debit side. Other items that would not be shown on the books are usually brought out by asking questions. On the question of commitments which have not been carried out, the question of plant extensions, and the question of goods that have been shipped on consignment—one could think of fifty reasons for suits. Then, one of those reasons might be translated into the actual beginning of a suit. I think that probably the

one thing that accountants do which develops more of this information than anything else is a request to the attorney for the client for a letter from him as to the suits which he is handling, or the cases in which he is interested. A great many accountants do that as a regular part of an audit.

MR. ORR: How do you estimate the possible liability in a case of that kind?

COLONEL MONTGOMERY: I will answer that in discussing another item which is one of the other things in which the accountant can be of some help in the preparation of a balance sheet for credit purposes, and that is in connection with taxes. We are constantly confronted with the difficult task of estimating unpaid taxes. We will never reach the point in this country, you know, where we will deliberately overpay your taxes. I think we will always take those doubtful items to which we think we are entitled and take a chance on fighting it out with the government, because we are driven to that. With the high tax rates you cannot do anything else. You have to make up a statement that is most favorable to yourself, which you believe to be honest, and then know that the doubtful items will be up for consideration and adjustment.

In probably half the concerns of the country there are potential tax liabilities. The accountant knows that today, and for the past ten or fifteen years it has been one of his great troubles, because the mere receipt of a letter from the Bureau of Internal Revenue saying that you owe \$10,000 does not mean that you owe \$10,000. On the other hand, if you take the Treasury statistics you will find that every time they send out additional bills for a billion dollars they get a lot of money. By questioning the officers of a concern—you do the best you can to ascertain the facts.

The same thing is true with suits. You ask, "What is the cause of action?" And that is one reason that accountants more and more are insisting on letters from the lawyers, because the lawyer says, "I am handling a suit which has been brought against this concern for \$10,000," and that is all he says in his letter. You call him on the telephone and you will say, "How much do you think you can settle for?" Very often he will say "We offered him \$1000." Now that is a starting point. It is somewhere between \$1000 and \$10,000, the amount that the accountant should put on the balance sheet. It is a difficult situation.

MISS L. M. GUTH: Do you think the accountant should read a commercial agency report on those firms whose books they are auditing?

COLONEL MONTGOMERY: Why not? I think that is a very good suggestion. I do not think anybody ever asked me that before, but I presume that a number of accountants employ such reports. I will ask Mr. Hughes, why shouldn't they?

MR. HUGHES: We do try to do that. I do not know whether it is unusual in some offices or not, but when we are preparing a statement obviously for credit purposes, we endeavor to get a good deal of outside information, and a commercial agency report is one of the things we try to get.

COLONEL MONTGOMERY: I jotted down here a list of different kinds of taxes, but I shall not go into all of them; it is a sad subject. But we are being taxed more and more and in more and more different ways, so that aside from

what the accountants do when they are on the job, I think that the credit executives will have to do a little more than they have done in the past in the way of making themselves familiar with the enormous tax liabilities which their customers are having to bear. The burden is getting heavier and heavier. It has an effect on something that is in the balance sheet as well as in the profit and loss account. That poor old profit and loss account which is outside of the balance sheet! I do not think it is necessary for me to go very much into that, it is so obvious to all of you, as it is to us today, that in so many respects it is so much more important than the items in the balance sheet. The balance sheet is something that happened, or was, yesterday. The profit and loss account up to yesterday is showing a trend; balance sheets do not show trends unless you compare a lot of years, and they are all down or all up, or something of that sort. But the concern that cannot make money in poor times may fail, as you know, and yet, at the same time, in the same line of business, there are concerns which are doing fairly well. I think you know much more about that than the public accountants.

I think it is realized, however, that the accountants are devoting more attention to the income account than they did in past years. I do not think accountants can get to the position which credit executives can take. You can take your balance sheet as of a certain date, (and I hope it is not always December 31st), and you can say, "What are your future commitments, and what did happen immediately after the balance sheet?" That could be tied up with the budget. What is going to happen in the three months and the six months following the balance sheet?" These new taxes are a highly important item in that forecast.

MR. HAIGHT: Before you take up another subject I should like to ask how far is it customary for accountants to go in looking into the matter of insurance protection in its various classes?

COLONEL MONTGOMERY: I think there has been an improvement in that respect. Accountants did not do very much with it some years ago—but gradually all accountants woke up to the fact that they could learn a lot by getting a statement of the insurance protection, because in the insurance schedules would be shown how much is on stock, how much is on machinery, how much is on buildings, and so forth. And that information affects several items in the balance sheet. It affects the depreciation item; it shows what the people themselves think of their inventories. So I think that generally speaking today, all accountants think it is an important item in an audit.

MR. HAIGHT: Do accountants mention it in the audit report?

COLONEL MONTGOMERY: As a rule, I think they do. Is not that so, Mr. Hughes?

MR. HUGHES: One of my associates says it is customary.

COLONEL MONTGOMERY: I think that is true, because enough has been said about the importance of it.

That brings up another thought, and that is that in almost all cases accountants make reports, prepare balance sheets, prepare income accounts, and

then in many more cases they are asked for the separation of the balance sheet and the certificate from the body of the report in order that it may be distributed. It does seem to me that the credit men should ask in more cases than they do for the reports of the auditors, and I think in nine cases out of ten they will find a reference to insurance. You would not find it on the body of a balance sheet.

A. ROTHSCHILD: With reference to that, what about the adequacy of insurance and the stability of a company in which the client carries his insurance? That is an important point because we want to know how good the insurance is, and that is a tremendously vital point these days. I think it has been largely neglected.

COLONEL MONTGOMERY: The Insurance commissioners say you can value your assets on the basis of say, July 1, 1929, or some other date so that your capital is not impaired. It is like the case of my house which was insured in a title company which failed. Now that is obvious.

MR. ROTHSCHILD: There are ways of finding out something about the stability of an insurance company outside of the companies themselves. There are insurance reports; there are insurance advisers; there are experts on insurance who can give you information as to the stability of companies in general; banks can give you information, usually as to insurance service and there is the Best Service that issues books and ratings on insurance. You could say in a report, "All these companies are rated A-1 in Best's," which is something; and there are other equally good sources of information, I should say. Now there is a question, particularly, on liability insurance that is more important than fire.

COLONEL MONTGOMERY: If there is any easy way of doing this, I would like to know it, and I am going to apply those suggestions by asking why we know so much today about suits being brought against a concern? It is because we use the lawyers, which we did not use to do. Practically every concern that places insurance does it through insurance agencies. That being the case, why not ask the insurance brokers, when they confirm the insurance in force, to note the rating of the companies in which they have insured our clients?

MR. ROTHSCHILD: That could be done. Of course, some brokers are very reliable and very fine houses, and a great many other brokers, particularly small firms, do not know anything about insurance companies except the collection of commissions.

COLONEL MONTGOMERY: Do you mean they might not furnish the information?

MR. ROTHSCHILD: They might not know it themselves. But the accountant can get the Best reports. He can get them from the public library if he cannot afford to subscribe.

COLONEL MONTGOMERY: We might not have enough margin of profit to afford such reports. If we could work every month in the year through adoption of the natural business year I think we could do that.

MR. ROTHSCHILD: May I say one thing more in connection with that sub-

ject. In this whole discussion we have been skating rather lightly over one very fundamental fact which is this: That the accountant is earning his living, and that the man who retains him is the client, the debtor, as far as we are concerned, and that he will not stand for more than a certain amount of cross-examination? After all, that is the practical question with most of the accountants, all except the very largest houses. The accountant cannot afford to go to his client and cross-examine him, because he would throw him out and get another one. That is a practical problem. Of course, there we run up against the situation that the man who is most interested in the accountant's report is not the man who retains him.

COLONEL MONTGOMERY: I referred to that, and I said that a delicate situation exists, but I do think that very substantial improvement has been made in that relationship. I do not agree that a great many accountants cannot or do not cross-examine their clients. I think today it is the rule for accountants to cross-examine.

MR. ROTHSCHILD: May I say that there are a great many accountants that cannot afford to cross-examine their clients too much? I did not say they do not. I brought up a practical question, and I think as far as the smaller accountant is concerned, it is largely true; he has got a hard fight for his bread and butter, I think, unless I am very badly misinformed, and he has to be careful, just the same as a credit grantor. The latter cannot cross-examine his customers too much either, because they will say, "I will go to the man around the corner who is quite as wise as you are and will give me credit." You come up against that delicate relationship all the time.

FRANK ABRAMS: In my experience, I found that the accountant usually does cross-examine his client, so to speak, if for no other reason but to strengthen his relationship with the credit men with whom his client does business. I have been in the credit field for fifteen years, and I have found that practically every public accountant with whom I have come in contact does cross-examine.

MR. BUCKINGHAM: The banks have a great deal to say about the accountant who is going to be used, and banks recommend the accountant. Then is not your allegiance more or less to the bank, or to the general merchandise creditor who is responsible for the accountant going into the situation? Are you not freer to talk to him, and do you not tell him more than you would ordinarily? I know it is a delicate matter.

COLONEL MONTGOMERY: The ideal situation is to have a client come to you and say, "We have been instructed by a creditor to employ you, and we are also instructed to tell you that you can talk freely with him." Now that is the ideal relationship, and I think that in most cases it can be brought about. That is one of the things that I had in mind when I spoke of talking with the accountant *before* the job is started. Many of you can do that but you wait until the report comes in, and then you ask him these delicate questions. You always first ask the question which he cannot answer.

MR. BUCKINGHAM: Is that what you mean when you say there has

been a big improvement in relations between the accountant, client and credit executive?

COLONEL MONTGOMERY: Yes. There has been a big improvement, because it is so easy when a substantial line of credit is being asked for, if you say to the person who is asking it, "You want us to give you this credit; you recognize the fact that today we expect accountants' reports on all credits of this size." The man is bound to say yes, because it is a known fact. "All right," the credit grantor continues, "we are interested in what that public accountant does. We want him to do a good job. If he does not do a good job you do not have to retain him again, but we want to know what he is doing. We do not want him to do too little or too much. We do not want you to pay any more for the job than the job is worth." Now, having said that, the credit grantor goes on to say, "We expect to talk to that accountant about your affairs." The client says, "Yes." Then you have that ideal relationship, and you have much more to do with bringing about that than has the public accountant. It is in your hands and the hands of the banks.

MR. BUCKINGHAM: Is it not true in many cases that an accountant may stretch an accounting point to conform with his client's views?

COLONEL MONTGOMERY: I have been practicing as an accountant since long before most of you were born, and I think that as a rule he deflates rather than expands. I honestly do. He does not stretch very often. But you know, there are lots of times in talking about a certain situation, a certain asset, a certain transaction, in which the accountant thinks a certain way. If he has a limited knowledge of the subject, it is just possible, you know, that the accountant may be wrong. There is that possibility, and after talking it over with his client and possibly asking the opinion of the New York State Society's committee related to the problem, he changes his views. He is not "stretching."

WILLIAM H. POUCH: Your remarks in reference to the budget are extremely interesting and fit in with the experience that the Advisory Board of the Federal Reserve Bank of New York is having with small industrial loans. We are endeavoring to get a forecast or a survey of the quarter years in the future. We have found that where a man knows his business those surveys have been fairly accurate, but where he does not know it the variations are as wide as the ocean.

COLONEL MONTGOMERY: As chairman of that board you consider it is a pretty good test to ask for it, do you not?

MR. POUCH: We have been at that now for close to nine months, and that has given us the experience of comparing the actual results with the surveys that they have made, and it shows a man up very quickly. You find a great many of the men, or the concerns or partnerships, are taking 1929, for instance, for their volume, and then using figures of today for their expenses. Well, of course, you know how to treat that person right away.

MR. ORR: Do concerns, to any extent, call in a certified public accountant

purely because they want to know the truth about themselves, or is it in connection with the establishment of their credit? Would many accountants' services be called for if it were purely and simply a matter of the officials of a concern wanting to know honestly about its affairs, without any regard to establishing its credit?

COLONEL MONTGOMERY: There are a great many such cases and I think that is demonstrated by the history of the last two or three years. Many concerns which have been losing money, a great many of which have not been borrowers but who could have been able to get the credit they needed without an audited statement, have called in public accountants just for the reason about which you inquire; and I think it is true that our expanding experience is responsible for that. That is the reason behind the choice of my subject for tonight. I think we have tried to get outside of the balance sheet and tried to bring our experience to bear on the problems of the business man on such things as the budget and various other things that have demonstrated their value, so that we think we have reached that happy situation where, if someone calls us in, he may not gain anything, but he has nothing to lose.

MR. ROTHSCHILD: I might have been too critical before, but to my mind that is the most useful function the accountant has, and I think you have been unduly modest about it. When I recommend an accountant to a customer I tell him, "You ought to have an accountant, not because I want to see your books, not because I want to know what is going on, but because it is going to do you good." I think that is the best way to sell him accountants' services.

COLONEL MONTGOMERY: I agree with you there, but you see, the public accountant, who, day by day, over a period of years, goes from one concern to another, finds himself accumulating so much valuable experience that if he keeps on along those lines, he will burst. He must consider sometimes that there are a lot of things that he does not know, and that is the reason that, appearing before the New York Credit Men's Association in past years, you used to be much more critical of me than you are tonight.

MR. BUCKINGHAM: I know that we have all been highly instructed with this talk. We have enjoyed it. More than that, we will go away with a great many new thoughts.

Inventory Methods of the Apparel Industry

By MORTON I. DAVIS, C. P. A.

THE apparel industry is admittedly one of the largest in the country with about 85 per cent concentrated in a circle with New York City as the center and the circumference line running through Connecticut, New Jersey, New York and Pennsylvania.

Despite this concentration, it is peculiarly distinct from other large industries in that the manufacture and distribution of apparel is spread among many thousands of entrepreneurs, the great majority operating on relatively small investments with a minimum of fixed assets. In fact, with the growth of the contractor or outside factory, the investment in plant and equipment has become insignificant.

It is the rule rather than the exception that the current creditor interest in a given business during the greater part of the year will exceed the total net worth. It is expected, moreover, that a manufacturer or jobber will sell and ship in a given year finished merchandise amounting to anywhere from seven to fifteen times his capital investment.

When, therefore, we take into consideration the highly volatile factors of style, seasonal changes, weather conditions and price fluctuations, it is easy to understand the high mortality rate in the industry.

From the statements so far made, it is evident that the main assets of the balance sheet are cash, accounts receivable and merchandise inventory. To the credit grantor, the most important of these is the merchandise inventory. The cash is verified by confirmation and accounts receivable are confirmed and aged and after setting up necessary reserves, are fixed and definite.

What of the inventory? It is nearly always the pertinent part of the statement. It represents anywhere from 25 to 75 per cent of the net worth. It may be priced in many different ways; it may contain old or obsolete merchandise; it may have overvalued sample lines and goods on memorandum and consignment.

Many years ago it became apparent to accountants practicing in the apparel field that unless guesswork was eliminated from the valuation of inventories, credit grantors would continue to be at sea and operating results would remain deceptive much to the detriment of the manufacturer himself.

In the ordinary course of general practice, the accounting profession, while accepting the responsibility on quantitative valuation, shied away from the accountability of qualitative valuation. The arguments for this attitude have been fully presented to you by speech and thesis. But in this particular industry, the responsibility cannot be evaded. Today it is no longer a choice as to whether you will accept this responsibility; it is a necessity forced on the profession by those who have great faith in our ability and integrity.

Describes Physical Procedure in Inventory Taking

Assuming that the necessity exists and the responsibility cannot be

evaded, I want to show by tracing the actual physical procedure in a given instance that an inventory can be taken properly and valued fairly.

We shall assume the inventory is being taken in a dress manufacturing organization, because in this particular branch of the apparel trade are exemplified the factors of style, seasonal changes, price fluctuations, etc.

The merchandise inventory of a dress manufacturer may be classified as follows:

Raw materials
Work in process

Finished garments
Sample line

In almost all instances at least two men are used. This is done in order to keep the premises under proper surveillance. During lunch hour one of the men should be present as insurance that no merchandise is shifted and subsequently taken again.

The client is notified several days in advance to assort the stock in such a manner as to facilitate its listing. All piece goods not representing full pieces should have been previously measured. Items in the trimming room requiring count should also have been fully counted and the total quantity should be marked on the box or other container. Finished goods should be assembled in such a manner that all garments of the same style should be together.

The inventory is listed on standard inventory pads in duplicate; one copy being retained for our files and the other for the client's use. So that no sheets shall be found missing, they are numbered in advance.

Before the actual count is commenced, a casual survey of the premises is made. This is done in order to plan the order of procedure so as to accord as far as possible with the client's wishes, and to cause as little disruption as possible with the regular business routine. Inventories usually are taken at the end of a season when business is slack and inventories are not at their maximum peak.

Cites Records that Should Be Sealed on Beginning Inventory

While this preliminary survey is being made all the records that deal with the ingress and egress of merchandise are sealed, that is, the last numbers are listed. This listing usually includes the numbers of the following records:

Sales book
Sales return book
Express receipt

Receiving record
Shipments to contractors
Purchase return

These are the usual records maintained, but there may be others, such as the shipments and receipts to dyers and spongers, charges to designing room, memo charges to embroiderers and pleaters and sundry other auxiliary records. In any event, all the last numbers of these records should be included in the list.

After this is done, the actual listing of the stock is begun. A good place to start is the piece goods room. The goods will be found usually to be sorted in some semblance of order based on quality and the type of mer-

chandise; that is, crepes, georgettes, chiffons, velvets, prints, woolens, etc. The goods are recorded in the order of location; that is, piece by piece, bin by bin, and shelf by shelf.

The following data pertaining to each piece is recorded:

Stock record number (if stock record is kept)	Description of goods (type of material and color)
Piece goods mill number	From whom purchased
Yardage	Price per yard

It is customary to have the stock clerk handle the materials and call off this information to the auditor, who can do the listing. Ample time is afforded to the auditor to observe that the data is correctly announced. The yardage may be verified on full pieces by noting that the original wrapper is still intact. If there is doubt as to whether it is a full piece, inspection must be made to see whether the edge of the piece retains the original mill perforation or sewed-in insignia. On materials not representing full pieces, an eye-test which may be developed after a little experience will be found to be adequate. Supplementing this eye-test, here and there, at random, after the stock clerk has announced the yardage, the auditor should insist that an actual measurement be made in his presence.

With regard to the description of the materials, this knowledge is a result of experience. Inasmuch as the vendor's name and mill number of the goods are being listed, reference to the purchase invoices will disclose readily whether the description of the goods is correct or not.

In listing the vendors, it is important to list such names as correspond with the manner in which the purchase invoices are filed. If the bills are filed under the names of factors or commission houses, the inventory listing should be made similarly. This will facilitate the checking of cost prices and other pertinent data for which the invoices have to be examined.

Urges Deferring of Pricing until Physical Count is Completed

In pricing materials, if the person in charge of the piece goods room is competent to do so and has the authority to make such reductions from cost as would represent the true value as at the date of the inventory, such prices may be listed at the time the inventory is taken. In any event these prices are not final, and are subject to such checks as will be described subsequently. It should be borne in mind that the original listing of inventory is primarily for the purpose of recording quantities, and deferring the question of price will expedite the count.

After a bin has been fully recorded, the total number of pieces should be recounted and checked to the inventory, to make sure that no piece has been overlooked. If the comparison shows that the total units do not correspond, this recount will localize the error and the missing or additional piece can be accounted for readily.

The listing of the piece goods should be made so as to segregate the merchandise to the season to which it is applicable. Separate groupings should be made for old and unseasonable merchandise. Such a segregation will be found to be helpful later when pricing is done.

Inquiry should be made at the time piece goods are itemized as to whether there is any material in the house on memorandum. This would apply also to goods for a new season that has not commenced for which advance dating has been received. It is a custom of the industry to exclude such merchandise from the inventory, and omit the liability from the accounts payable for balance sheet purposes. Where this is done a proper footnote is made, and in order to enable the verification of the total amount, an inspection of such merchandise should be made at the time the inventory is taken. An examination of piece goods awaiting return should also be made. Such merchandise may be on hand at the time the inventory is taken due to the failure of the creditor to call for it. If such return charges are bona fide, as evidenced by subsequent receipts which the audit later will disclose, such merchandise may also be excluded from the inventory figure in the balance sheet. At all events a complete record should be made of all goods in the house whether it is the intention to include same in inventory or not, so that there will be no question later on as to the whereabouts of the goods at the time the inventory was taken.

Inquiry should be made also of goods out of the house for which title has not passed. This would apply to materials at dyers, spongers, converters, etc. The recording of such merchandise should be done to enable outside verification.

States Principles Applied to Pricing Piece Goods

The pricing of the piece goods is based on the following principles:

1. Current and staple goods are valued at cost, and where such cost has declined by the date of inventory, the lower price is applied to the entire lot of such merchandise. In arriving at such cost full deduction is made for trade discounts applicable thereto.
2. Where goods are carried over from a previous season, or for which the season had recently been terminated, a markdown is taken. The extent of such markdown is based upon whether such goods is in ready demand or is of the novelty type. This often is a matter of judgment. Such judgment is predicated on the amount of such merchandise involved, the past experience of the client and the availability for use of such merchandise in the future. Very often such merchandise may be rendered useful by dyeing to another color. In this latter instance the value would be determined by subtracting from the replacement value of the same goods in seasonable colors, the cost of dyeing, with a further allowance to cover the shrinkage entailed in the dyeing process. Thus, for example, if a manufacturer were left with a quantity of novelty goods such as printed velvets costing \$6 a yard, and they could be substituted for ordinary black velvet, currently in demand, having a value of \$4 a yard with a shrinkage allowance of 5 per cent and a dyeing cost of 30 cents a yard, the value could be determined by subtracting from \$4—the 5 per cent, or 20 cents, and 30 cents for dyeing, bringing the net value to \$3.50.
3. Old and unseasonable merchandise for which no vogue has existed for a considerable period of time should be priced at its salvage value.

Without going into all the ramifications of the question, extreme conservatism in pricing is used where any doubt exists.

The question of pricing is related closely to the verification of the fact as to whether the manufacturer is really the owner of all the goods he has in the house. For this reason the listing of the mill piece numbers is very important. While it is not necessary to check back every individual piece to see whether a proper invoice exists therefor, the check should be made sufficiently comprehensive to include all classes of piece goods. Failure to find invoices for specific piece numbers in any considerable quantity should make a more intensive check necessary, and if need be, communication should be made with the vendors to ascertain that such goods had actually been sold to the manufacturer in question.

The next step in the inventory procedure would be to take and price the items in the trimming room. Very often a detailed itemization is not necessary and an acceptable round sum valuation may suffice. Where, however, the trimming room contains any considerable quantity of furs, laces and other expensive materials, an actual count should be made. By this is not meant that every button and buckle in the place should be counted. As previously mentioned, the person in charge of the trimming room should have previously prepared the stock in such a manner that an adequate test check can be readily made.

Laces and expensive ribbons should be itemized and checked in a manner similar to the piece goods. Due to the fact that laces frequently are imported it is important to take the duty into consideration when check is made to the original invoices for the purpose of pricing. Furs which often are particularly expensive should be checked in complete detail.

Many odds and ends and leftovers, trimmings of previous seasons, accumulate in an establishment that has been in business for any length of time. These items, while having a high initial cost, have little or no utility, and the value placed thereon should be extremely nominal.

Checking of Work in Process

The next step in the inventory procedure would be to take the work in process. A good plan to adopt is to follow the merchandise in the order of the manufacturing process. This order may be outlined as follows:

Cutting	Finishing
Assorting	Draping
Operating	Pressing

The goods in the cutting department may still be in the raw state, partly cut, or entirely cut. In the raw state it is inventoried and valued in the same manner as piece goods. Where it is partly or entirely cut the original yardage may have lost its identity. In this instance the yardage is not listed but instead the listing is done by style and quantity. In arriving at this information, work tickets usually will be found from which the data may be secured.

The goods at assorters represent fully cut merchandise tied together in bundles. Here again the information desired may be secured from the work

tickets. If such merchandise is considerable, a bundle here and there may be opened and the count verified.

The amount of goods in work at operators and finishers may be determined by passing from one work bench to another and recording it.

The dresses in work in the remaining departments are usually in such a state of completion as to be hanging on racks from which a count can be made readily.

Goods in process are valued at the net cost of materials plus the cost of the completed labor operations. No allowance is made for factory overhead or for any labor operation not entirely completed. This is done in order to tie up with the accrual for factory labor which will be made as part of the regular audit.

The net cost of material and the cost of the various labor operations may be ascertained by reference to the payroll records for labor, and to cost calculation records for the cost of materials. Care should be exercised in examination of the cost calculation record to ascertain that the yardages and price of materials entered therein represent true cost. The figures should not be taken for granted as they often will be found to be excessive.

It should be borne in mind that manufacturers are not accountants, and their conception of cost may differ widely from that of accountants.

Inventorizing the Finished Goods

The next step in the procedure is to inventory the finished goods. This merchandise will be found usually in the stock room and shipping department assembled on racks. As previously mentioned, the assembly of the garments will facilitate the count. The listing should be done by individual styles and the quantity of each. To insure that all such garments are the bona fide property of the company, the N. R. A. label is of great assistance since each label contains each individual manufacturer's three letter symbol; an examination of these labels virtually precludes the possibility of another's goods being substituted.

Before the finished goods count is completed, it should be insisted that all sales return packages, applicable to the period prior to the inventory date, should be opened and that such garments be included in stock. A full record should be made of such merchandise so that proper adjustment may be made for audit purposes.

Inquiry should be made concerning all finished goods out of the house, such as salesmen's samples, goods at stock houses or out to customers on memorandum. Such merchandise should be added to the inventory after confirmation of it has been received.

In pricing the finished goods, current salable merchandise should be valued at the cost of material and labor. This is done in the same fashion as work in process, by reference to the cost calculation record. Where a manufacturer has come down to the end of a season with a stock of garments that cannot be shipped out on regular orders, he probably will have to dispose of such merchandise in job lots. Such goods should not be valued at

cost as previously described, but should be taken at such a price as will yield the normal percentage of gross profit when sold. In order to ascertain the extent and amount of such job sales, it may be advisable to defer its calculation, until such time as the sales actually are made. This may take place shortly after the inventory date but before the audit is completed. The valuation of damaged and shopworn garments may be similarly arrived at.

Treatment of Samples

The next step in the procedure is to count and compute the value of the sample line. These garments usually will be found in the sample and designing rooms. In listing these garments each style should be individually recorded. This is important in order to ascertain to which season they are applicable. The fact that manufacturers use a different number series for each season will aid in such differentiation. Care should be exercised that no duplicates or original samples are included. Notation should be made of any samples imported from abroad from which domestic copies are made. Such imports usually are brought in under bond, and after they have served their purpose are resold to a customer in a foreign country at a fraction of their cost, in order to avoid the payment of duty. Such garments are tagged specially which assists in identification.

The samples in process in the designing rooms are listed similarly, together with such notations as will describe the stage of completion.

Samples for a new season for which no manufactured stock has been made up are valued at cost. Where the auditor is experienced in this line he has a fair idea of such cost and usually can place a fair round sum average valuation per sample. If he wants to provide a check on his valuation, the cost of producing the new sample line may be determined by computing the total designing salaries, sample hands labor and materials consumed, for the period that the sample rooms were in operation in the production of the line. This may be done by examination of the payroll records, and the record of material charges to the designing room. By making this calculation he can arrive at the total cost of the new sample line, or provide a check on the average figure he has used.

Samples of a season already passed are worth no more than ordinary stock garments, in fact even less. This is due to the fact that they have already served their purpose, and because of their constant handling in display are shopworn. They should be valued on the same basis as garments which are sold as jobs.

At this stage the inventory on the premises is completed. There is one additional factor, however, to be taken into consideration. This is the inventory at contractors.

It would be well, at this point, to explain just what the function of the contractor is as applied to the apparel industry. A contractor is one who performs some or all the necessary labor to convert raw materials into finished garments for the benefit of a manufacturer or jobber. He maintains an independent factory of his own which is under his supervision. The raw

materials are supplied to him by the manufacturer. The title to these materials remains vested in the manufacturer, making the relationship one of bailor or bailee.

Position of Contractor in Dress Industry

The economic justification of contractors may be outlined as follows:

1. The manufacturer usually occupies premises in a high rental area. To maintain a large factory of his own on the same premises as his showroom would involve a high overhead cost. The contractor is not so situated.
2. By employing contractors the manufacturer saves an investment in plant and equipment and thus avoids tying up his capital in fixed assets.
3. By employing contractors the manufacturer can avoid labor troubles, a condition that has been chronic in the apparel industry virtually since its inception. The contractor assumes the burden of this problem or avoids it by going to a community that has not been unionized and where an abundance of cheap labor may be found. Since the advent of the N. R. A. this avoidance has been to a great extent eliminated, and manufacturers are being held directly responsible for conditions at the shops of their contractors.
4. By the use of contractors a manufacturer is able to standardize and exactly predetermine his labor cost.
5. The last, and perhaps most important reason of all, is that by the use of contractors, the manufacturer secures elastic production facilities. Due to the highly seasonal nature of the industry a sudden rush of orders in mid-season would strain the facilities of a fixed manufacturing plant. By adding or cutting down the work given to contractors, the manufacturer can expand or curtail his productive capacity to meet his requirements.

As has been previously pointed out, the materials at contractors belong to the manufacturer, and properly should be included as part of his merchandise inventory. In certain instances, which are comparatively rare, it may be expedient to take a physical inventory at the contractor's premises. In these cases the procedure would be similar to the method used in taking the goods of the manufacturer in process. In the majority of cases, however, this procedure is not expedient and other measures have to be used.

As part of his records, the manufacturer maintains a production record showing the styles and quantities of dresses in work at each contractor. When the production record is accurately kept, it would be a comparatively simple process to make a listing therefrom of the materials at contractors, obtain a confirmation of them, and the problem is solved.

But it is a rare case, indeed, when such an ideal situation exists. Experience has shown that in a vast majority of cases the production record is not accurate and it is virtually impossible to secure an accurate confirmation from the contractor. Furthermore, the production record is not a book of account and the entries made therein are not subject to the usual checks governing an actual book of account. It is, therefore, necessary to make an analysis of the contractors' accounts in the contractors ledger. Such an

analysis will provide not only the information that is sought, but may be used in connection with other phases of the audit. Without going into too great detail, this analysis will determine:

1. The inventory at contractors
2. The liability to contractors for labor
3. The disclosure of irregularities or errors in the contractors' accounts requiring adjustment.

Inventorying Goods at Contractors

In connection with this last function of the analysis, it may be mentioned, in passing, that the contractors' account is a favorite breeding place for all kinds of differences, and items in dispute.

One of the main features of this analysis is to determine the markup of materials charged to contractors. This markup represents the excess over actual cost of materials so charged. The markup feature is an almost universal practice in the industry. The markup varies with different manufacturers, and even is not always uniform in a particular concern. The percentage of markup as based upon the shipment price varies anywhere from ten to forty per cent.

Without going into the entire mechanics and mathematics of the contractors analysis, which is an entire subject in itself, it is sufficient to state that the objective is to ascertain and reverse the charges for materials on the contractors premises, eliminate the fictitious profit called markup, and take these materials into the manufacturer's own inventory on the same basis as if they were on his own premises.

Gathering the results together in regulation form is simple enough and the inventory is then complete.

There are many problems related to inventory taking in the apparel trades where honest differences of opinion exist or more particularly where there are adroit attempts made to circumvent the ascertainment of a true valuation. That, however, is a subject in itself and is at the moment beyond the scope of the immediate objects of this article.

It has been my desire to establish the following facts:

1. That the apparel trades as distinguished from other large industries operate on limited investments, largely current.
2. That the inventory of merchandise is an important and sometimes the most important asset on a balance sheet.
3. That the credit granting community demands, and we must assume the responsibility of an honest valuation of the inventory.
4. That under the method of procedure outlined, it is feasible and practicable to arrive at such a fair valuation.

It is to the everlasting credit of the accounting profession that it is meeting daily the growing demands of its clients and of credit granting agencies. Certainly in this field we are definitely meeting their challenge.

Presented at a meeting of the New York State Society of Certified Public Accountants held on April 22, 1935.

Accountants and the Public Service

By GEORGE S. VAN SCHAICK

I USED to be ill at ease whenever I came in contact with a certified public accountant. I have always had an idea that I might feel particularly uncomfortable in the presence of a large group of certified public accountants. I find now that is not true. I have learned it on this occasion and also while I was in the State Insurance Department, because I had occasion to use the services of men of your profession probably more widely than has any other public official.

It did occur to me, however, that while I was able and privileged to use certified public accountants in the emergency work in the department, that it was a great pity that the public service is not more frequently favored by the services of men and women of your profession.

When I came to the Department I was impressed with the fact that it was under-manned. I suppose that was the situation all over this country, both in banking and in insurance. The supervisory departments so far as examination of companies are concerned have been notoriously under-manned. We fail to appreciate that until we come to times of depression and the depression was pretty well along, as you will recall, in March, 1931, when I received appointment and confirmation to the position of superintendent.

From the very beginning I attempted to get the state of New York to realize that the Department was under-manned and that it needed very much more in personnel, both in quantity and in quality. All through the four years that I occupied that position I used every effort at my command both with the Legislature and otherwise to see to it that some attention be given to the remedying of a condition which ought never to have been permitted to exist.

I did not get very far with that crusade. I did not get far in building up the Department although step by step it was strengthened; 1932 was better than 1931, 1933 better than 1932, and so on in each successive year until as we look at it today we see that there is a very decided difference in the personnel of the Department in regard to its investigations from what there was when I came to the Department early in 1931. The present superintendent of Insurance needs help, the superintendent of Banks needs help when it comes to proposals for expenditures of more money for more efficient supervision of financial institutions. Nobody knows, of course, more than the men of your profession how much is needed in the improvement of companies that are under state and national supervision. That reference is made to no particular company, I am just speaking of the matter in a general way when I say there is need of improvement.

Urges Larger and Better Qualified Insurance Examiners

When I asked for a Moreland investigation of the Insurance Department, there was a twofold reason. I wanted, of course, to lay the cards

on the table in regard to what the Department was doing in the rather critical situation presented by the title and mortgage companies. At the same time I realized that only in some such manner could there be brought to public attention the needs of the Department. In the report of the Moreland commissioner and in the review of the problems presented and the way they were handled, the Moreland commissioner supported us in our demand for a more efficient and larger personnel in the Department.

How could this personnel be secured? In 1931, when I asked for more people, what was said: "All right, you may have more examiners—temporary examiners." It can be seen immediately how little that helps, particularly in a crisis, when a person in order to be an efficient company examiner must have had years of experience and training along particular lines in order to do the kind of work that is needed.

A temporary examiner is fine as a makeshift, but a temporary examiner as a solution of the problem was but a slight step forward.

There came a time when the Department was given permanent examiners in greater number, then it was given a group of examiners at higher salary than that paid to the juniors, and these were special claim examiners. Two years ago I came forward with a proposition which has made but little progress and in which I think I ought to have your cordial support. You are in a position to help. That proposal was that in time of emergency a supervisory official ought to have a revolving fund which would enable him to engage whatever competent people are necessary to do the work.

In times of crisis there is needed a force large enough in any supervisory department that can get work done promptly and efficiently. If a supervisory official were given a revolving fund it would not cost the State anything in addition because the expenses of examinations are charged back to the companies examined.

If the Department of Insurance were given a revolving fund whereby it could go out to your organization and other organizations and engage for the time being the needed people to help in the necessary examinations, it would be tremendously helpful to any supervisory department in doing the work which it must do in the public interest.

Suggested Revolving Fund for Emergency Employment

Two years ago I made that suggestion to the Legislature but the proposal did not succeed. This year in the report which I made to the Legislature I expressed the matter as follows:

"In his last report to the Legislature the superintendent stated:

"The modernization of governmental methods is slow at best. A superintendent of Insurance should be given not only ample means for the employment of accountants and examiners, but a latitude and discretion as to expansion as circumstances demand. This can be done by the appropriation of a revolving fund properly safeguarded as to its use by the consent of the Governor or comptroller or financial leaders of the Legislature, available for necessary expenditures in examination work."

"The Moreland commissioner in his report makes a similar suggestion. Legislation has been prepared providing a revolving fund for use in meeting emergencies that may confront the Department hereafter. The superintendent unhesitatingly recommends and urges its enactment into law."

The Senate passed the bill but it died in the Assembly. No one seemed particularly concerned or interested except the Insurance Department. Here is something of public service which your organization might do. If you would put the force of your personnel and your prestige behind such a proposal you could do much to convince the Legislature that there is something here that is so fundamentally sound that there should be no question of its enactment.

Again I say, it would not cost the State a single cent. It is only the matter of putting up a revolving fund for use, when needed, to be charged back eventually to the companies examined. It seems almost unbelievable that so simple a suggestion as that should not meet with instant approval.

I have been very much interested also in the selection of examiners, and have been concerned as to why the State does not attract more young men of ability, who ought to be interested in the great work of public service.

Says Examiners Need Thorough Knowledge of Accountancy

In my 1931 report, I stated, perhaps, one of the basic reasons why the State cannot attract the type of people that it ought to in its regular appointments. I said something about the qualifications of an examiner, within a few months after I came to the Department, as follows: "An examiner should have a thorough knowledge of accounting, know and understand the Insurance Law, be capable of sound judgment, tactful, and a man of good character. The present salary scale paid to examiners in this Department is entirely out of line with the ability required and the responsibilities imposed."

As a matter of fact, I think it is true that while the salaries range in the examining force from \$2400 a year for junior examiners to \$7500 for the chief examiners, the average pay of the examining forces in the Insurance Department is less than \$3000.

To get the proper type of people a greater salary ought to be paid. How ridiculous it is that we cannot get the Legislature to fix those salaries on an appropriate basis. Again it is not a question of State expenditure because the large part of examination expense is charged back to the companies examined.

The State ought to be fair to the companies that are going to pay the bill. It is, nevertheless, economy to companies to have an examination made by competent people; made by enough people so that the examination can be done promptly. Sometimes the more you pay the greater economy it is in the end. Yet it seems to be almost impossible to get the State to recognize the fact that to get the right type of people, to get certified public accountants into the State service in greater number than we have, that some attention should be given to the matter of making the salaries of examiners sufficiently attractive to bring them into the public service.

I remember the first time I went to the Budget Committee, presided over by the Governor, at which were present the Legislative leaders of finance. I remember one of the Legislative leaders saying to me in reference to my asking for more junior examiners: You are paying \$2400 a year—I know a State where they get them for \$1800 a year." That was the attitude as we went along. In order to get greater help we were up against a reluctance to improve the quality of our examiners by a raising of salary standards.

I do not want you to get any wrong ideas because of what I have said about strengthening the forces of the Department. I have the highest regard for the faithful men and women who served year after year and sometimes worked hours that are almost unbelievable, particularly during the crisis. The backbone, of course, of all great Insurance Departments are the civil service workers that have been there year after year. The faithfulness with which they have performed their duties is appreciated by no one more than by me. There was thrown on their shoulders in this depression a burden that was almost unbelievable when you stop to analyze what this pitifully small handful was called upon to do.

Service Improvements Seen Through Attracting Accountants

I do say, however, it is no discredit to them and not any failure of appreciation of their services to assert that the standard of service can be made immeasurably higher if the State will only begin to give attention to attracting more competent young men and women to the service than are in it at the present time.

When we come to the matter of appointing temporary examiners, as I recall it back in 1931, we had to take appointees from the civil service lists. It was very proper that we should, but the civil service lists did not always give us the people that we needed. After one has exhausted the people who stand along the head of the list for quite a ways, one finally gets to the dregs of the list. Until another list is selected those are the people from which selections have to be made. It is no wonder that you get all manner of people in an examining force when the State does not exert itself to attract to its civil service examinations all the very best qualified persons available.

Now again, I do not want to be misunderstood because we have taken very many fine and able people from those lists. The State would be the gainer if those lists could be improved and get more young people, particularly of your profession, interested in taking these examinations. There is much that your organization can do. I wonder why an organization such as this does not have a committee to cooperate with the State Civil Service Commission at Albany to review the matter of the examinations which are given for examiners and see whether sufficient attention is given to accounting experience and accounting training and all those things with which you are particularly familiar in order that those accountants who are best qualified will be attracted to the examination rather than certain other people with other lines of experience not as valuable as accounting experience.

You may find that the Civil Service Commission has done everything that

can be done but you may also find that your organization could make very many valuable suggestions. I feel sure that the Civil Service Commission would be glad for suggestions along the lines of strengthening examinations. Certainly the Insurance Department and, I feel sure, the Banking Department also would like to have something done so that from year to year as the lists are made up and appointments are made the eligible lists would be of increasingly higher caliber.

It is a great thing to be in the State service. At best it does not pay as well as people are paid in private affairs. There is a zest, an inspiration which comes from being a part of a government which has important governmental functions and is intent on doing them—there is zest and inspiration in the work that will appeal to every one, particularly the younger men who are coming along in your profession. I hope that your organization will become more active in stimulating interest in the public service among your members.

Urges Cooperation of State Society

I suggested to the president of the New York State Society another fine thing that this organization might do. I feel very badly that while I was superintendent of Insurance I did not have personal contact with this organization. I came to the Department at a time when it became necessary to take over large companies and it became necessary, not through the regular channels, but through the Rehabilitation Bureau to employ outside of the Civil Service, accountants to ascertain facts as to the condition of the companies taken over. It became necessary for me to employ many people of your profession.

I knew very little about accountants, I knew very little of the personnel of the accountants of the metropolitan district. I had as chief of my Rehabilitation Bureau, a man of my own personal selection regarded by me as the most skillful liquidator and he had one instruction from me. I passed on to him the instruction the Governor had given to me. The Governor said to me he wanted the job done right. As far as I was able, that instruction was carried out and that was the instruction I gave to all my deputies including my deputy in charge of Liquidations and Rehabilitations. He was told to let no other consideration come into the picture and to get the best accountants he could at fair compensation. I believe that was the sole basis upon which the work was done by him and by other deputies who acted for me in the selection of personnel. Perhaps if we had had the assistance and counsel of an organization such as this, we might have done better. Perhaps in many ways we could have strengthened our work. That is the point I want to make.

I think any superintendent of Insurance, the present one or any of his successors, would be delighted, particularly regarding accountancy which is looming larger and larger as the years go on, to have the cooperation of your officers, and a committee devoted to that purpose. Such cooperation would be of great help in the selection of accountants by the Department.

I can speak for no one other than myself when I say that but I tell you frankly, I regret tremendously that I did not have that benefit while I was at the Department.

Presented at the second Chapter Conference of the New York State Society of Certified Public Accountants held at Skaneateles, New York on June 28-29, 1935.

Auditing of Municipal Accounts

By HARRY T. O'BRIEN

FOR the purpose of local self-government, New York State is divided into counties, cities, towns and villages in number as follows:

Counties, exclusive of counties within New York City	57	Towns	932
Cities	60	Villages	554

In addition to the foregoing which by law are denominated "municipal corporations," there are also two groups of quasi-municipal corporations. One is school districts numbering about ten thousand and the other is public improvement districts numbering more than twenty-five hundred.

The school districts are separate legal entities, managed in some instances by a single trustee or a board of three trustees and in larger districts by a Board of Education.

The public improvement districts are subdivisions of towns set apart in unincorporated areas for special purposes such as the improvement and lighting of streets, the construction of sidewalks and sewers, and the collection and distribution of water for domestic consumption and for the extinguishment of fires. These districts were managed formerly by commissioners elected by the voters within the district but at present, except in cases where the commissioners have been retained by a vote of the people, are under the management of the town boards. Unfortunately, the township is required to issue bonds when bonds are required to finance districts of this character with the right, however, to collect by taxation the amounts needed to pay the annual maturing installments of the bonded debt.

Fire, fire alarm and fire protection districts differ somewhat from public improvement districts in that bonds issued by these districts are based solely upon the credit of the district and not upon the credit of any other municipality.

State Gets Authority Over Municipalities' Fiscal Affairs

In 1907, under authority of a statute popularly known as the "Wadsworth Law" the comptroller of New York State began to exercise more or less control over the fiscal affairs of the municipalities above referred to, except the school districts which still remain under the jurisdiction of the Department of Education with permissive power to the comptroller in the case of such districts having a population of more than five thousand.

At that time there were no precedents to follow and each man had to use his own judgment as to the methods to be followed. The first examinations were made in the county offices, a virgin field, and, strange to say, the first examiners who were appointed and charged with this difficult and unusual task were lawyers and not accountants.

It is amusing now to recall these early reports and to find that almost invariably these pioneers began their written reports in uniform phraseology which ran something, although not exactly, like this:

"On the day of your examiners called at the office of the treasurer of the county of and immediately proceeded to count the cash on hand."

There would follow an itemization of the checks, the currency, even the postage stamps; and sometimes, I am sorry to say, a reference to a slip of paper, sometimes called an I. O. U., which indicated a temporary use of public moneys for a private purpose.

The examiners always admonished the public officer that he exceeded his powers when he advanced public funds to himself or to his friends and warned him not to do it again or to take the consequences following official activity on the part of the district attorney.

Mishandling of Public Funds

I recall an instance where a city clerk was expected to have on hand a considerable sum of money from license fees and other miscellaneous revenues as shown by his cash book. When one of our inquisitive examiners asked permission to count the cash nothing was found in the safe where it was presumed to be except an empty wallet.

On the next day the money had mysteriously found its way into the safe in exactly the correct amount. The clerk, apparently satisfied his conscience, having been jarred into activity by an unexpected visitor having authority to examine his books. But he either did not know or forgot the results which follow the discovery of a violation of the criminal law. An energetic district attorney presented the facts to a grand jury, whereupon, in due time there followed an indictment for grand larceny, a plea of guilty, a suspended sentence, and worst of all, from the clerk's point of view, the loss of a job.

At a date which at this time I am unable to fix definitely, the work of examiners in the Bureau of Municipal Accounts became described as "audits" and "examinations."

When an examiner is assigned a task he is told to make either an audit or an examination. If it be an audit, it may embrace all the accounts in a municipality, or the accounts of a board, officer or commission. If it be an examination, it usually covers all the accounts of the municipality. The essential difference between the two is that whereas an audit means only the verification of the correctness of recorded receipts and disbursements, an examination means an audit and a study of all of the transactions of the municipal officials, including a decision on the part of the examiner as to the legality or illegality of official action.

In this connection it occurs to me to refer to the mild surprise which follows when an examiner who is thoroughly acquainted with controlling statutes finds himself puzzled by some practice or other which does not follow the letter of the law. The official whose work is under examination is inclined to show just a little condescension when he is asked to explain a practice he has followed for years. He raises his eyebrows in surprise and subconsciously wonders why this "expert from Albany," as he calls him,

should question the legality of something which he himself has done for years and which, as the official says, has been done by his predecessors for many years. If the examiner knows the law (as men in the Bureau of Municipal Accounts are expected to) he usually has the last laugh when he refers to the statutes and shows the official that under such circumstances he is required to do thus and so; whereupon the official being, as most of them are, a reasonable man, replies, "Well I'll be darned."

One official gave as an excuse for his action that he had followed in the footsteps of his illustrious predecessor and when asked when his predecessor left office he replied, "forty-eight years ago."

Following precedent, unless the precedent is sound, is a dangerous practice, and many a public official has had to be told that he, as well as the municipality of which he is an officer, has no authority except such as may be conferred by statute. With all due respect to public accountants, thoroughly familiar as they usually are with correct business practices, they forget the limitations imposed on public officials and sometimes appear to believe that a correct balance sheet and a reconciliation between book balances and cash on hand, including bank deposits, is all that is required in an audit of the accounts of a municipality.

Where State and Counties Receive Bulk of Revenue

The principal source of revenue in all of the municipalities in New York State is the direct tax on real estate. Other miscellaneous items of revenue are as follows:

Bank taxes	Personal income taxes
Mortgage taxes	Franchise tax on business corporations
	Alcoholic beverage taxes
and in counties:	
Motor fuel taxes	Motor vehicle fees

According to the report of the Bureau of Municipal Accounts, transmitted to the Legislature for the year 1934, each dollar of revenue receipts of all municipalities in combination consisted of the following:

Property taxes	\$.610	Gifts and grants.....	\$.255
Other taxes015	Departmental earnings...	.035
Special assessments015	Public utilities045
Interest015	All other005
Licenses and fees.....	.005		<u>\$1.000</u>

Each municipality has an official charged with the duty of collecting property taxes who is known as receiver, collector, or in the case of counties and cities, treasurer.

The office of receiver of taxes and assessments is found only in so-called towns of the first class;— all other towns have town tax collectors. These officials report to the county treasurers, except in Westchester County where the town is the unit for all tax collections and the supervisor performs duties in connection with the collection of delinquent taxes which in all other counties devolve upon the county treasurer.

Upon the expiration of the time fixed in the warrant annexed to the tax rolls these collecting officers return the rolls to the supervisors or the county treasurers, as the case may be, and settle with such officers by payment of cash and delivery of a statement of uncollected taxes.

After the return of these taxes subsequent proceedings result in the publication of a list of delinquent taxpayers and a tax sale.

Tax Sale Notices Assist Examiner

The information contained in the notice of tax sale serves a twofold purpose in that it informs the public of the names of delinquents and gives an auditor something definite to rely on in determining whether or not the collector or the treasurer has accounted for all of his collections.

Tax sales are not popular with local officials, because the element of sympathy enters, and sometimes political expediency, because instances have been known where pressure has been brought to bear to postpone or to omit this drastic remedy.

Where tax sales are not held periodically an examiner has no certain method of verifying the correctness of tax receipts, except by circularizing the taxpayers, a slow and unsatisfactory method.

In verifying the correctness of receipts of other than real property taxes, which I have called miscellaneous items of revenues, the examiner applies to the State Department of Taxation and Finance or to the Bureau of Revenue in the Department of Audit and Control.

Special assessments usually are entered on special assessment rolls, although sometimes combined on a tax roll and the correctness of receipts from this source usually is verified by reference to numbered stubs of assessment bill books or, as in the case of taxes where no tax sale has been held, by inquiry of persons whose names appear on the rolls.

The amount of interest collected by a public officer may always be ascertained by inquiry at a bank, while the items of licenses and fees and gifts and grants are from uncertain sources and difficult to verify.

"Departmental earnings" is another item difficult to trace with absolute accuracy, although in most municipalities a record of some kind will be found in the departments which will give a careful examiner a clue, even though the entry may be only a memorandum on the back of an envelope or a lead pencil scrawl in a greasy and well-worn note book.

Auditing of Receipts from Public Utilities

In connection with this class of receipts, I recall the experience of one examiner in one of the largest villages of the state where, by dint of careful work, he discovered that considerable sums of money paid by public service companies for the privilege of making openings in the streets had not been recorded in the treasurer's books. By reference to the records of the several companies the amount of the defalcation was ascertained to be about \$6,000. The treasurer who had just been appointed to a lucrative and probably lifelong job in a county office, admitted his guilt, lost his new job, and spent a term in prison.

Receipts from public utilities embrace earnings from water and light departments and present difficulties to a conscientious examiner more serious than are found in connection with any other class of revenues. With reference to these revenues each man follows his own methods in an effort to arrive at correct results. To date the municipalities operating water and light plants are not numerous and hence the problem has not been serious.

In any event, since the electric utilities are under the supervision of the Public Service Commission they are required to make reports to the Commission which furnish examiners in the Bureau of Municipal Accounts a satisfactory working base.

The verification of the correctness of the items on the disbursement side of the accounts of a municipality is a comparatively easy matter when only an audit is to be made.

As a rule each disbursing officer will have some evidence of payment either in the form of a receipted bill or, if these be missing, a cancelled check.

In the case, however, of examinations, it is the duty of the examiner to scrutinize closely all of the claims audited and paid and this involves an inquiry as to whether or not each claim has been properly itemized and verified; whether or not the amount is within the budgetary appropriation, and whether or not the expense represented by the claim is one which properly may be incurred by the municipality.

Certified Public Accountants Urged to Perform Municipal Audits

An examiner making an examination must investigate the validity of bond issues, determine whether or not the proceeds of the bonds have been used for the purposes for which the bonds were authorized and whether or not at the time of the authorization the municipality's debt was within the constitutional or statutory limitation.

An ideal examiner must not only be a capable accountant but must likewise have a thorough knowledge of very many of the general laws of the state.

In special instances, also, he must familiarize himself with charters and other local laws and use the best judgment of which he is capable in interpreting statutes which are sometimes difficult to understand.

When the Bureau of Municipal Accounts was established in 1907, little or no attention had been given to this field by certified public accountants.

During the past ten years, however, the Bureau has had no monopoly of this business because certified public accountants generally have found it a desirable field in which to work.

It is believed there is plenty of room for all of us and since our staff is wholly inadequate to meet the demands upon our time, a desirable result will follow if accountants generally give this field of practice the attention which it deserves.

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